

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
CORE RETAIL REAL ESTATE**

October 18, 2004

This Policy is effective immediately upon adoption and supersedes all previous core retail real estate investment policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Core Retail Real Estate Portfolio ("the Portfolio"). The design of this Policy ensures that investors, managers, partners, members, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Portfolio. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with the Portfolio.

II. STRATEGIC OBJECTIVE

Achieving the highest risk-adjusted total rate of return possible is the strategic objective of the Portfolio. This objective shall reflect prudent levels of risk, the liabilities of the System, and the investment guidelines contained herein.

The Core Retail Real Estate Portfolio shall be managed to accomplish the following:

- A. Provide diversification;
- B. Preserve investment capital;
- C. Generate attractive risk-adjusted rates of return for the System;
- D. Provide a hedge against inflation;
- E. Provide stable cash flow from operations;
- F. Provide appreciation potential; and
- G. Consider solely the interests of the System's participants and beneficiaries in accordance with California State Law.

III. PERFORMANCE OBJECTIVES

- A. Exceed (after fees) a minimum target real rate of return of 5.0%; and
- B. Exceed (before fees) the National Council of Real Estate Investment Fiduciaries Index ("the NCREIF Index") while maintaining an appropriate level of diversification to mitigate risk.

IV. ASSET ALLOCATION

Subject to the Statement of Investment Policy for Equity Real Estate, the following is the current asset allocation range for the Core Retail Real Estate Portfolio as a percent of the total Equity Real Estate Portfolio:

| | <u>Range</u> |
|------------------------------------|--------------|
| Core Retail Real Estate Portfolio: | 10-35% |

From time to time, the actual allocations may fall out of the ranges prescribed by Policy. In these instances, the System shall implement adjustments to correct the actual allocations to comply with the Policy allocation ranges within a reasonable time frame. Implementation that occurs within a three-year period, with ample consideration given to preserving the System's investment returns, is considered a reasonable time frame.

V. INVESTMENT APPROACHES AND PARAMETERS

A. Diversification

The Portfolio shall reduce risk through appropriate diversification. Diversification shall occur primarily by geography and investment strategy as outlined below.

1. Diversification by Geography

The Portfolio shall be comprised primarily of investments in the United States. The Portfolio shall contribute to the overall geographic diversification objectives of the Core Real Estate Portfolio as specified in the Statement of Investment Policy for Equity Real Estate.

2. Diversification by Strategy

Retail property subtypes are categorized depending on retail concept, project size, anchor tenants and the size of their respective trade areas. The System shall balance the Portfolio within allocation ranges for the property subtypes. The allocation ranges established for each of the retail

property subtypes are a percentage of the Core Retail Real Estate Portfolio listed below:

| <u>Property Subtype</u> | <u>Allocation Range</u> |
|-------------------------|-------------------------|
| Malls | 10 - 90% |
| Shopping Centers | 10 - 90% |

The System shall employ a broad range of strategies for core retail real estate investments. The allocation ranges established for each of the property classifications are a percentage of the property subtype category. To mitigate risk, the System shall place less emphasis on strategies carrying a greater degree of risk and uncertainty.

| <u>Property Classification</u> | <u>Allocation Range</u> |
|--------------------------------|-------------------------|
| Stabilized | 40 - 100% |
| Value-Added | 0 - 40% |
| Development | 0 - 20% |
| Land | 0 - 5% |

The Senior Investment Officer of Real Estate may allow a specific core property sector to exceed the 10% Speculative (less than 75% pre-leased) Development level as long as the **overall** Core Portfolio Speculative Development level **does not** exceed 10%.

3. From time to time, the actual allocations of various geographic sectors and investment strategies may fall out of the ranges prescribed by Policy. In these instances, the System shall implement adjustments correcting the actual allocations so they comply with the Policy allocation ranges within a reasonable time frame. Implementation that occurs within a three-year period, with ample consideration given to preserving the investment returns for the System, is considered a reasonable time frame.

B. Investment Objectives and Criteria

1. Malls
 - a. Malls are generally defined as larger retail properties offering a broad variety of shopping goods, typically spanning general, apparel, furnishings and other merchandise categories. Mall offerings generally

emphasize fashion-oriented goods as opposed to discount-oriented goods or commodity retail products. Malls typically incorporate traffic-drawing anchors into the project mix to draw customers from large regional trade areas. Malls are often anchored by traditional full-line department stores, junior department stores, specialty department stores, general merchants, large-format home furnishings stores, large-format sporting goods stores, multiplex cinemas and / or hotels. Regional Malls typically exceed 400,000 square feet. Super Regional Malls typically exceed 800,000 square feet. Specialty Fashion Centers are typically smaller than Regional Malls. Malls also often feature out parcels that are leased to single tenants.

- b. Investment objective is to generate cash flow returns with appreciation potential.
- c. Investment Criteria
 - (1). Institutional grade properties;
 - (2). Properties that dominate retail trade areas;
 - (3). Emphasis on major metropolitan markets;
 - (4). Joint venture ownership structures with mall operators or wholly-owned;
 - (5). Strong locations with visibility and access to public and private transportation routes;
 - (6). Each property shall produce a minimum five-year real IRR (after fees) of 5%;
 - (7). Each property shall produce an appropriate risk-adjusted return; and
 - (8). Additionally, new acquisitions shall require an acceptable stabilized cash return (for Development, measured after completion and initial lease-up).
- d. Property Classification Criteria
 - (1). Stabilized
 - (a.) An operating Mall property that upon acquisition has mall shop area at least 80% leased to a typical mix of retailers.

- (b). Reclassification to Valued Added when less than 80% leased.
- (2). Value Added
 - (a). An operating Mall property for which an expansion, re-leasing or re-positioning is planned or in progress with the objective of yielding higher total returns than a Stabilized property and upon acquisition is at least 40% leased but less than 80% leased.
 - (b). Reclassification to Stabilized when at least 80% leased or to Development when less than 40% leased.
- (3). Development
 - (a). A property to be developed and to be leased to a typical mix of Mall retailers or to be re-developed and upon acquisition is less than 40% leased.
 - (b). Reclassification to Value Added when at least 40% leased or to Stabilized when at least 80% leased.
 - (c). Speculative Development is a Development less than 75% pre-leased.
- (4). Land
 - (a). Undeveloped, vacant land intended for development of Mall properties.
 - (b). Reclassification to Development upon commencement of construction.
 - (c). Locations will be selected from supply-constrained markets, strong retail development areas or strategic in-fill locations;
 - (d). With regard to entitlements, land acquisitions that meet the following criteria:
 - (i) Zoned for retail Mall development;

- (ii) Free of governmental restrictions concerning retail Mall development (including, but not limited to, no-growth initiatives, building moratoriums, and conflicts with general plans); and
 - (iii) Reasonably expected to receive site plan approval.
- (e). Environmental compliance is met when a satisfactory Phase I environmental report is completed prior to land acquisition.

2. Shopping Centers

- a. Shopping Centers are generally defined as smaller retail properties offering a variety of shopping goods typically focused on the general merchandise and convenience categories. Shopping Center offerings generally emphasize necessity retail products as opposed to fashion-oriented goods. Shopping Centers typically incorporate anchors to draw customers from surrounding neighborhoods and serve smaller trade areas than Malls. Shopping Centers are often anchored by supermarkets, drugstores, home improvement stores and / or discount department stores. There are three subtypes as follows: Neighborhood Centers are typically smaller than 150,000 square feet. Community Centers typically range from 100,000 to 350,000 square feet. Power Centers are large Community Centers that typically range from 250,000 to 600,000 square feet. Shopping Centers often feature out parcels that are leased to single tenants. Additionally, triple net leased single tenant properties are included.
- b. Investment objective is to generate cash flow returns with appreciation potential.
- c. Investment Criteria
 - (1). Institutional grade property;
 - (2). Generally, building age of 20 years or less from original construction or renovation;

- (3). Locations with supply constraints or high growth characteristics;
- (4). Strong locations with visibility and access to public and private transportation routes;
- (5). Dominant anchor tenants with strong credit;
- (6). Continuous operating clauses in anchor tenant leases, if attainable;
- (7). Ratio of small shop space to total shopping area is generally 35%;
- (8). Strong demographics in trade area;
- (9). Each property shall produce a minimum five-year real IRR (after fees) of 5%;
- (10). Each property shall produce an appropriate risk-adjusted return; and
- (11). Additionally, new acquisitions shall require an acceptable stabilized cash return (for Development, measured after completion and initial lease-up).

d. Property Classification Criteria

- (1). Stabilized
 - (a). An operating Shopping Center that upon acquisition is at least 85% leased.
 - (b). Reclassification to Valued Added when less than 85% leased.
- (2). Value Added
 - (a). An operating Shopping Center for which an expansion, re-leasing or re-positioning is planned or in progress with the objective of yielding higher total returns than a Stabilized property and upon acquisition is at least 40% leased but less than 85% leased.
 - (b). Reclassification to Stabilized when at least 85% leased or to Development when less than 40% leased.

(3). Development

- (a). A property to be developed to be leased to typical Shopping Center retailers or to be re-developed and upon acquisition is less than 40% leased.
- (b). Reclassification to Value Added when at least 40% leased or to Stabilized when at least 85% leased.
- (c). Speculative Development is a Development less than 75% pre-leased.

(4). Land

- (a). Undeveloped, vacant land intended for development of Shopping Centers properties.
- (b). Reclassification to Development upon commencement of construction.
- (c). Locations will be selected from supply-constrained markets, strong residential development areas, or strategic in-fill locations;
- (d). With regard to entitlements, land acquisitions that meet the following criteria:
 - (i). zoned for retail Shopping Center development;
 - (ii). Free of governmental restrictions concerning retail Shopping Center development (including, but not limited to, no-growth initiatives, building moratoriums, and conflicts with general plans); and
 - (iii). Reasonably expected to receive site plan approval.
- (e). Environmental compliance is met when a satisfactory Phase I environmental report is completed prior to land acquisition.

VI. GENERAL

- A. Terms in this policy are defined in a master glossary of terms.
- B. Unless otherwise noted, investors, managers, consultants, partners, members or other participants selected by the System shall base all calculations and computations on Fair Market Value, as defined by the Uniform Standards of Professional Appraisal Practice (USPAP) of the Appraisal Foundation for accounting purposes. See Statement of Investment Policy for Equity Real Estate Appraisal and Valuation Policy.

VII. GLOSSARY OF TERMS

The Real Estate Glossary of Terms is referenced in the System's Master Glossary of Terms.